BBVA

Real Estate Watch
Peru

Economic Research Department
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- Impacts of the crisis in the real estate sector
- What is the public sector doing to mitigate them?
- Real estate outlook for 2010

Index

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Executive Summary

Real estate activity, which up until the beginning of 2008 was growing at rates near 20%, has been experiencing the impacts of the international financial crisis in recent months.

From the demand side, the effects are expressed in a consumer that is more cautious and averse to debt, due to an environment of greater uncertainty from the sluggishness of the job market. Likewise, from the supply side, construction companies' expectations have also deteriorated, and they believe that they are facing stricter requirements for gaining access to credit than those that were in effect a few months ago.

It should be mentioned that, as a product of the current situation, the costs of building materials have gone down in recent months, particularly those of iron and finishing materials for construction. In general, it is estimated that costs may go down 5%, which gives a certain leeway to these companies to reduce their sale prices without sacrificing their profit margins.

As a result of this dynamic in the real estate sector, monthly mortgage payments have gone down, although they are showing a certain trend towards recuperation beginning in May. At the same time, mortgage interest rates have shown a decreasing trend since February, but they have not returned to the levels they were at in September 2008 yet. Other indicators continue to show a healthy trend: that is, the delinquency rate remains at a low level and the value of the dollar continues to diminish.

In this context of downturn, the government is adopting a series of measures to stimulate construction growth, and in particular, real estate activity in Peru, principally through the Techo Propio (Own Roof) program. In fact, the stimulus from the public sector would explain about 50% of GDP construction growth during 2009.

Aside from these programs, the government could focus its future efforts on stimulating the mortgage loan market. A financing alternative that is being evaluated are covered bonds, although we estimate that this type of bond could take a few years to be consolidated in the Peruvian market.

In the coming years, the expectations for the sector continue to be favorable, due to structural factors such as the current housing deficit, population group trends, the possibilities of the penetration of mortgage financing, and also the solid macroeconomic foundations of the country (high potential growth, macroeconomic stability, investment level).

I. Impacts of the crisis in the real estate sector

Real estate activity is highly procyclic (see **Chart 1**) and it experiences a greater volatility than GDP, highs just as much as lows. Therefore, in the current context of low economic growth, it can be observed that the Peruvian real estate market is experiencing a rapid downturn. Diverse supply and demand factors, as well as real estate funding requirements explain the development of the sector since the last quarter of 2008.

1. Demand factors

The consumer with more caution about spending and less disposed to going into debt

In an environment of greater uncertainty associated with the weak product expansion that is expected this year, the average Peruvian consumer has become more cautious in his/her spending, and as a result, is choosing to postpone purchasing decisions. In particular, according to a survey done in December 2008 by Ipsos Apoyo Opinión y Mercado, 35% of urban consumers prefer to reduce or postpone the purchase of durable goods such as automobiles or real estate (see **Chart 2**).

Another characteristic that the survey revealed is that 40% of consumers wish to reduce their level of debt. This is very relevant to the real estate sector, given that the purchase of real estate normally requires bank financing. In this way, consumers would be postponing their purchasing decisions until a better opportunity presents itself or until they generate sufficient savings to be able to limit the necessary debt.

The principle reason that consumers have become more cautious is their perception about the conditions of the labor market. Likewise, the work component of the consumer confidence index reached a minimum of 36 points in April 2009, after having an average of 45 points at the beginning of 2008.

It should be mentioned that the creation of jobs has slowed down and in some sectors, such as manufacturing (above all, the activities that are oriented towards exportation), are declining (see **Chart 3**). In any case, other sectors such as commerce and services, are maintaining a positive behavior, with a labor market that continues to grow. Overall, the unemployment rate in the Lima Metropolitan area (in seasonally adjusted terms) has grown by nine tenths between the second quarter of 2008 and the second quarter of 2009, going from 7.4% to 8.3%.

2. Supply factors

Construction companies have faced a series of changes in this environment, which go from construction costs (supplies, labor, and land) to the variations in the expectations of demand growth.

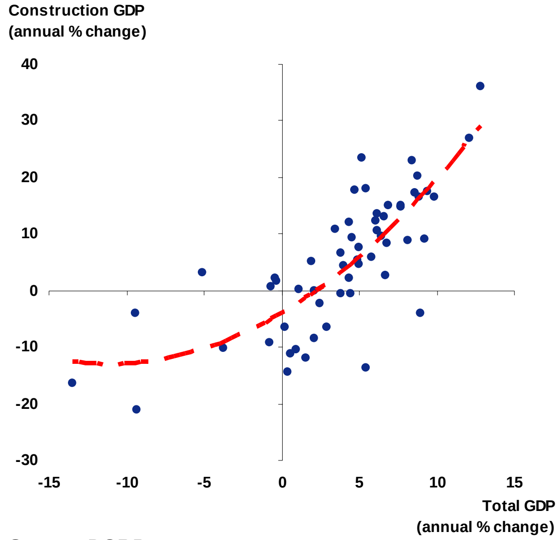
Decline in the expectations of construction companies

According to the latest construction sector surveys from the Central Bank, the expectations of construction companies have declined in recent quarters (see **Chart 4**). For example, from the expectations of the sector for the next 3 months, only 11% of the companies expect improvement, while 16% expect a decline in the sector's activity. On the other hand, during the first 3 quarters of 2008, around 60% anticipated growth in the sector, and only 2% expect a decline.

Supplies costs decline in mid-crisis

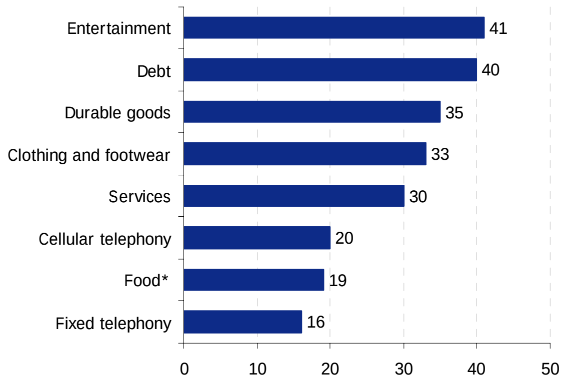
After experiencing a yoy growth of up to 17% up to September 2008, the prices of construction supplies began to decrease, in line with the prices

Chart 1: GDP and construction GDP (var. annual %)



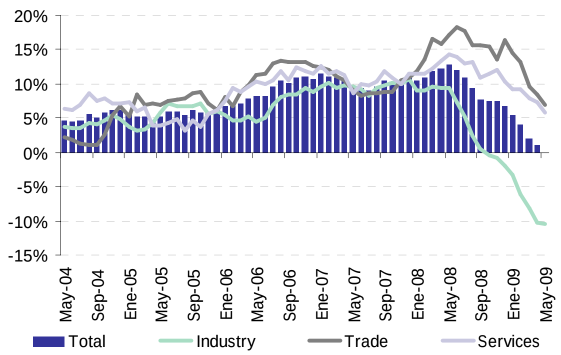
Source: BCRP
Prepared by: BBVA Economic Research Department

Chart 2: Consumer expense reduction activities



*Replace with lower priced brands and products
Source: IPSOS Support Opinion and Market
Prepared by: BBVA Economic Research Department

Chart 3: * Employment in the Lima Metropolitan area (var. *yoy %*)



Source: INEI
Prepared by: BBVA Economic Research Department

for commodities and other industrial goods in the world. At the close of July, the Index of Building materials (IMPC) had a level similar to that of March 2008, and was 12.3% below its peak of September 2008 (see **Chart 5**). It should be mentioned that, except in the case of agglomerants (concrete) and cement, the decline in materials and supplies has been generalized. The most noticeable case is that of metallic supplies (rods for construction), which at the close of July had fallen 40% with respect to its peak. This dynamic is associated with the evolution of the international price of steel, which followed the trend of decline of other metals like copper and zinc.

For business owners in the sector, the decline in the price of supplies helps to relieve the needs for financing and working capital. According to market sources, the materials used in one construction (including the external structure and finishing materials) can represent up to 40% of the total cost. In this sense, the decline in the price of building materials would have an influence of up to 5 percentage points in the total cost for business owners in the sector.

Cost of labor could change in the coming months

In contrast with the supplies situation, the costs associated with labor, which represent 30% of the total cost, have not declined. In fact, according to the permanent survey on employment and income from INEI, average hourly wages in the first semester of 2009 have increased 21% in terms of the similar period from the previous year (see **Chart 6**).

It should be mentioned that, in Peru, the majority of workers in the construction sector are unionized through the Civil Construction Workers' Federation of Peru (FTCCP). The leaders of the union meet yearly with representatives of the Peruvian Construction Chamber (CAPECO) and negotiate, among other things, their salary expectations.

At the beginning of August, the negotiations corresponding to the period of July 2009 - June 2010 were concluded, having arrived to an agreement to increase salaries an average of 4.5% (in its list of requests, the FTCCP demanded an approximate increase of 20%).

High prices for purchased property limit price declines

During the rapid expansion that the construction sector showed in the first half of the decade, property prices in the Lima Metropolitan area increased, due to a combination of high demand on the part of real estate agents facing a relative shortage on the supply end. Therefore, only in 2008, Capeco estimates that the property prices (which can represent up to 30% of the total cost) increased by 30%.

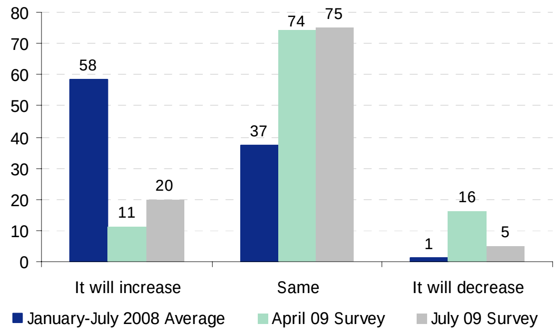
YTD in 2009, there is not much information available with respect to the evolution of property prices, due to a low number of transactions. In any case, according to the consulting firm Rodrigo & Associates, the prices of some properties for real estate projects in Peru have shown a 10% drop so far in 2009, despite the great caution of investors in beginning new constructions. Utilizing a more conservative estimate (5%), we estimate that the decline in property prices will have an influence of 1.5 percentage points on the costs of construction companies.

Construction companies with room to maintain margins

Taking into account the expected evolution of the construction companies' costs, we estimate that a gap of at least 5 percentage points exists so that the final sales prices can be reduced, without the necessity to generate a decline in profit margins (see **Chart 7**).

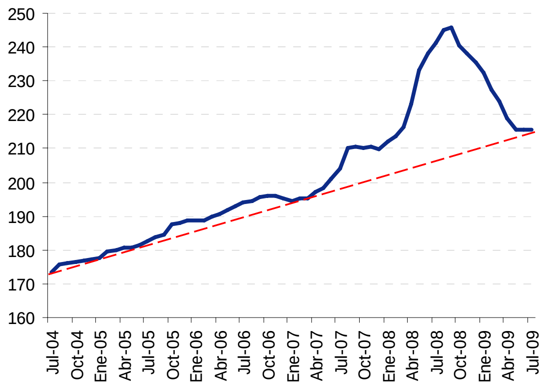
It should be indicated that this calculation is only referential, due to the fact that some companies could be affected by a temporary market gap between costs and income, especially those that have concluded construction works in recent months and are not able to sell all of their real estate.

Chart 4: Construction sector companies' outlooks ***(to 3 months - %)***



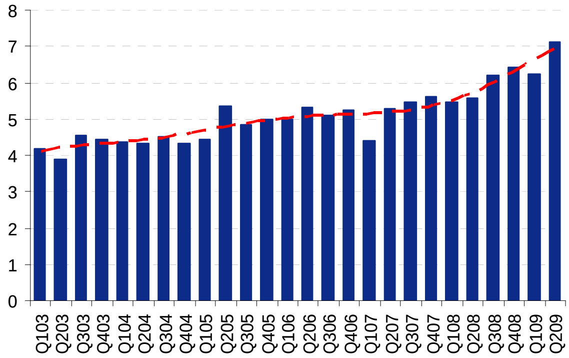
Source: BCRP
Prepared by: BBVA Economic Research Department

Chart 5: Building materials price index ***(dic.01=100)***



Source: INEI
Prepared by: BBVA Economic Research Department

Chart 6: Income of construction sector workers ***(S/. per hour)***



Source: INEI
Prepared by: BBVA Economic Research Department

The slowdown of economic activity has not only affected the housing property market, but also other similar markets like the that of offices and shopping centers.

1. Effects on the office market

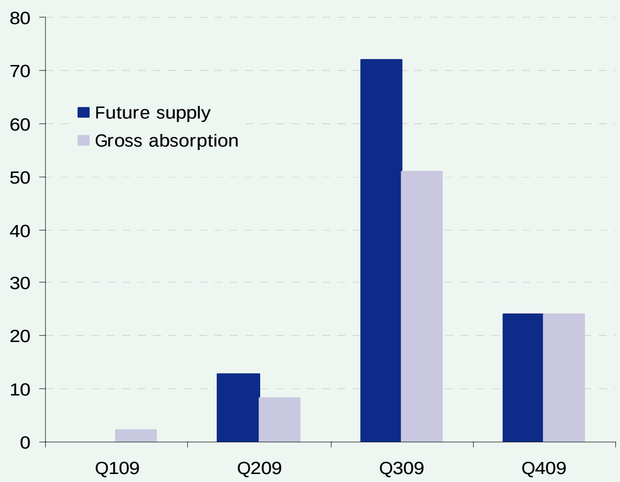
Before the economic activity began to experience a slowdown, Lima's office market was characterized by a very low vacancy rate (close to 1%) and high demand, factors which placed pressure on purchase prices and up-selling. Within this context, construction companies like AESA (Brescia Group) and Centenario (Romero Group) focused on constructing office buildings.

Thus, during the first half of the year, the supply of offices increased by 12,700 square meters, which correspond to Towers 1 and 2 of the Cronos project. In turn, despite the absorption (occupied spaces) in the Cronos building reaching 9,600 m2, the net absorption was only 3,400 m2, due to the fact that in most cases, the spaces had been occupied by transnational companies in the process of relocating, and not by companies that had recently arrived to the country. In any case, the vacancy rate rose to 2.7%, after a minimum of 0.7% at the close of 2008 (according to market sources, a “healthy” vacancy rate is calculated to be around 8%).

Rental prices per square meter have slightly decreased year-to-date, from US$ 16.30 per square meter at the close of 2008 down to US$ 15.60 in the second quarter of 2009 (4% drop).

In upcoming months, Lima’s office market will continue to incorporate spaces that are currently under construction, and which will not be completely absorbed by current demand (see **Chart I**).

Chart I: Future supply and gross absorption in the office market (thousand m2)



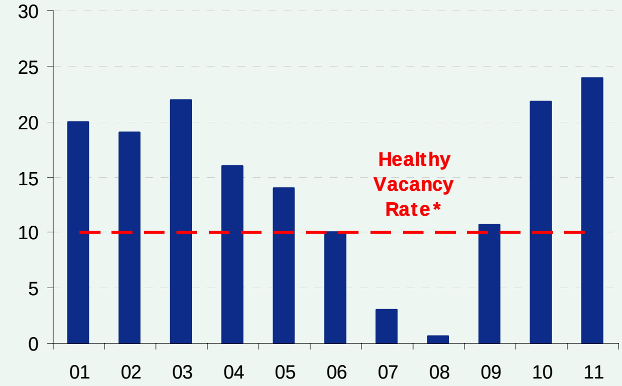
Source: Colliers International

In fact, the third quarter will be the year’s most active, with more than 70 thousand new square meters, distributed throughout seven buildings. The net absorption (considering the spaces that are unoccupied due to relocation) of the spaces shall be 35,000 square meters. Thus, the vacancy rate could reach 10%.

On the other hand, looking towards 2010, it is possible that signs may arise of excess supply in the sector, due to both new developed projects and to greater caution on the part of the corporate sector, which could enter a review stage in its plans for relocation or entry into the Peruvian market.

In fact, according to Colliers, the vacancy rate will continue to rise in 2010 and 2011, until it reaches levels upwards of 20% (see **Chart II**). Upon the generation of this oversupply, there will be downward pressure on sale and rental prices, especially in projects with less than 50% occupancy.

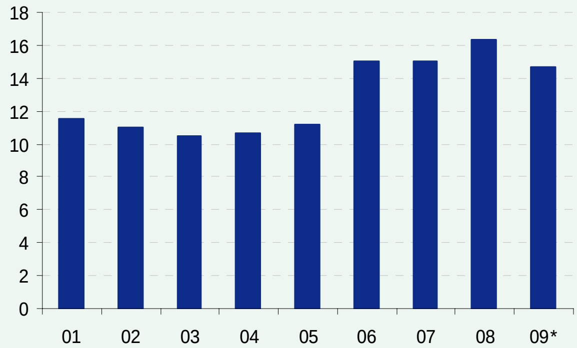
Chart II: Vacancy rate in offices (%)



*Understood as that which does not place pressure on rental prices
Source: Colliers International

Within this context, we estimate that average rental prices in the office market could reach US$ 14.70/m2 at the close of 2009, 10% less than at the close of 2008 (see **Chart III**).

Chart III: Rental price (end of period - US$ per m2)



* Forecast
Source: Colliers International

Lastly, it is possible that those projects announced for 2010 and 2011 that have not yet broken ground may postpone or definitely cancel their projects, unless they reach a presales minimum of 40%. This could generate a certain balance in the market and take some of the pressure off the prices.

2. Effects on the shopping center market

Despite the lower dynamic activity of the economy and consumption, the building of shopping centers in Lima and the main provinces of Peru has continued full force year-to-date 2009. It has even exceeded the investments made in 2008, a year which boasted 6 openings (see **Table I**).

Table 1: Shopping Center Openings in 2008

Project	Location	Developer	Investment (million US$)
Mall Aventura Plaza Bellavista	Lima	Mall Aventura Plaza	80
Real Plaza Huancayo (Phase 1)	Huancayo	Interbank Group	30
Plaza del Sol	Ica	Romero Group	29
Los Jardines Open Plaza	Trujillo	Malls Perú	26
Open Plaza Canta Callao	Lima	Malls Perú	20
Real Plaza Pro	Lima	Interbank Group	10
2008 TOTAL			**195**

Source: Colliers International, BCRP
Prepared by: BBVA Banco Continental ERD

In any case, it is true that certain international players such as Falabella and Cencosud have postponed some of their projects due to greater caution on their part when investing and favoring an adequate liquidity situation. Along these same lines, the Wal-Mart supermarket chain announced that although Peru is in its plans, it will not enter the market in 2009.

On the other hand, local operators continue to invest in this activity, working towards greater penetration into the country's modern consumption. Thus, the first half of 2009 has been characterized by the opening and launching of projects that continue to strengthen modern retail trade, while the portfolio projects for the next two years are realizing that the shopping center boom in Peru will continue at least into 2010 (see **Table II**).

Table II: Shopping Center Investments 2009-2010

Project	Location	Group	Investment (million US$)	Opening date
Plaza Lima Norte	Lima	Wong	150	Q209
Open Plaza Surquillo	Lima	Malls Perú	100	2010
Mall Aventura Plaza Arequipa	Arequipa	Mall Aventura	80	2010
Mall Aventura Plaza Santa Anita	Lima	Mall Aventura	80	2010
Real Plaza Puruchuco	Lima	Interbank	60	2010
Real Plaza Centro Cívico	Lima	Interbank	45	Q409
Mega Plaza Este	Lima	Parque Arauco	40	2010
Open Plaza Piura	Piura	Malls Perú	30	2010
Primavera Plaza (renovation)	Lima	Interbank	20	2010
Real Plaza Arequipa	Arequipa	Interbank	18	2010
Centro Comercial Imperio	Lima	Torvisco	15	Q409
Strip Center Chorrillos	Lima	Parque Arauco	4	Q409
Plaza del Sol (expansion)	Piura	Romero	4	2010
Strip Center La Victoria	Lima	Brescia	4	Q409
Strip Center Caminos del Inca	Lima	Brescia	4	Q110
Plaza Fundación Faucett	Lima	Los Portales	3	Q409
2009-2010 total investment			**656**	
Memo: Investment in Lima (% of the total)			*80%*	

Source: Colliers International, BCRP
Prepared by: BBVA Banco Continental ERD

Thus, at the end of 2008 and beginning of 2009, large shopping center projects were incorporated all over the country, the most noteworthy of which are Mall Aventura Plaza Bellavista (US$ 80 million) and Real Plaza Huancayo (US$ 30 million).

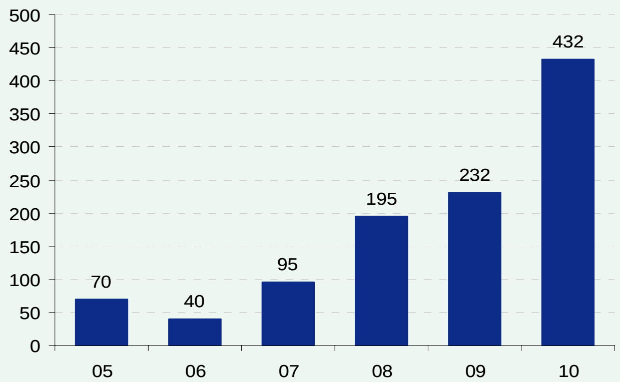
Likewise, the largest opening of 2009 took place during the second quarter: the first phase of the Centro Comercial Plaza Norte, located in the district of Independencia (Lima Norte). Once the work is complete, the total investment is expected to reach US$ 150 million, in an area covering 200,000 square meters.

With regard to the rest of the year, the most important opening will take place in the third quarter, with the opening of the Real Plaza Centro Cívico (Urbi Propiedades) in the Cercado de Lima district, with an investment of US$ 45 million. Expansions will also be carried out in the country's main shopping centers: Jockey Plaza, Megaplaza and Plaza San Miguel.

Another format that would prove to be dynamic is strip centers (small shopping centers), which are designed for smaller spaces. Each one can demand an investment of up to US$ 4 million, and up to 5 of them are expected to enter into different areas of the capital during 2009.

Lastly, for 2010, openings in business premises will continue in Lima and the provinces, led under the brands Real Plaza, Aventura Mall Plaza, Open Plaza and Mega Plaza (see **Graph IV**). In total, investments in shopping centers that will open exceed US$ 400 million (without counting the opening of supermarkets, department stores or home improvement stores, which are not located in shopping centers.

Graph IV: Shopping Center Investments*



* Based on opening year
Source: ACCEP, BCRP, Colliers International
Prepared by: BBVA Banco Continental ERD

One of the largest shopping centers that will begin its activity in 2010 is Open Plaza Surquillo (associated with Falabella). Works for this project started in the second quarter of 2009 and the total investment will reach US$ 100 million. Other large investments set for 2010 will be located in Lima Este: Real Plaza Puruchuco (US$ 60 million) and Mega Plaza Este (US$ 40 million).

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These companies may be harmed by a situation in which they built when costs were at their peak, and they will have to sell with a declining sales price trajectory.

3. Bank financing for the sector

A. Real estate companies: more demanding conditions

At the close of June 2009, commercial loans for the construction sector and real estate activities were at S/. 6.4 billion, 9.3% less than the peak reached in December of the previous year (see **Chart 8**). This decline can be explained by more demanding requirements needed to obtain bank financing, and also by a lower demand on the part of the developing companies.

Likewise, the presale bank requirements for disbursement to real estate developers has been increased up to 50% of the total of residences built, when in mid-2008, said percentage fluctuated between 20% and 30%.

In this context, according to the IX Survey of the Construction Sector from the Central Bank, developing companies have reported a greater difficulty in accessing loans from the banking system. Therefore, as of April 2009, only 6% of companies considered that they had easy access to credit (30% at the beginning of 2008).

In any case, it is important to note that, at least for the moment, more demanding financing requirements do not have a significant impact on companies from the sector, due to: (i) the financing that they request is normally very short term, so eventual increases in the interest rate have a marginal impact, and (ii) the companies obtain important working capital inflows starting with the presale agreements made with clients.

B. Mortgage Loans: Stabilization in recent months

The mortgage lending market has lost, in recent months, the dynamism that it had over the last 5 years, even though it is still maintaining a modest growth. At the close of June, the balance of mortgage loans in the banking sector was at S/. 11.331 billion (US$ 3.762 billion), 17.4% more than the same month of the previous year (see **Chart 9**).

It should be mentioned that the credit flow of mortgage loans has had a mixed evolution in recent months. In this way, after having arrived to an average monthly inflow of S/. 200 million in the third quarter of 2008, the pace of the new mortgage loans reduced by 50%, reaching a monthly average of S/. 100 million in the first quarter of 2009. Finally, in the second quarter the average monthly pace increased to S/. 150 million.

In terms of the pace of growth, mortgage loans grew 2% monthly up until the third quarter of 2008, while YTD in 2009, monthly growth has been reduced to 1%.

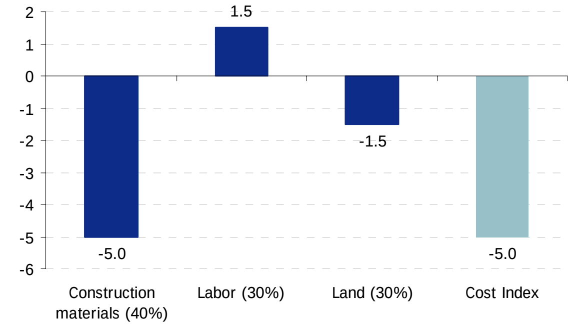
B.1. Mortgage interest rates: correction after an increase in fourth quarter 2008.

Interest rates for mortgage loans have shown a decline so far this year, although they remain above the previous levels from the third quarter of 2008 (Lehman Brothers bankruptcy, see **Chart 10**).

Therefore, since March 2009, interest rates in Soles and Dollars show a gradual correction, after they increased between September and December of the previous year. This change is explained by a lower global risk aversion, after having reached historic peaks at the end of 2008.

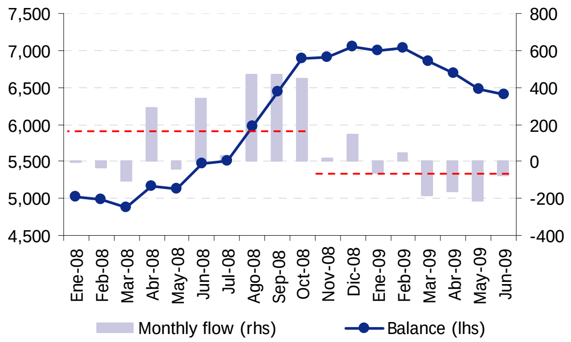
In the case of interest rates in Soles, they declined 150 bps between March and July, going from 11.7% to 10.2%. In any case, this is a higher rate than the 9.7%, the average of said rate in the third quarter of 2008.

Chart 7: Evolution of the costs of construction companies *(percentage points)*



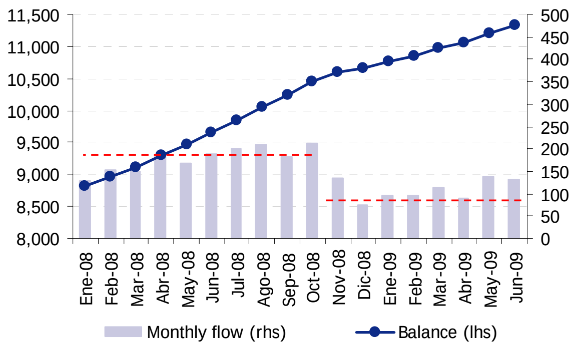
Prepared by: BBVA Economic Research Department

Chart 8: Commercial loans to the construction sector* *(in millions of S/.)*



*Includes loans for construction real-estate activity
Source: SBS
Prepared by: BBVA Economic Research Department

Chart 9: Mortgage Loans *(S/. millions)*



Source: SBS
Prepared by: BBVA Economic Research Department

In terms of spreads, the interest rate for a mortgage loan in Soles is equivalent to the yield of the Sovereign Bond 2026 plus 370 bps, less than the spread of 490 bps in May of 2009, although above the average level of 250 bps in the first quarter of 2008. The reason that this spread became larger could be attributed to a larger risk that the national currency declines with respect to the Dollar over the next few years.

On the other hand, in the case of interest rates in Dollars, these showed a decline of 70 bps between March and July, going from 10.8% to 10.1%. This rate remained above the average level of 9.5% in September of 2008.

In terms of spreads, the interest rate for a mortgage loan in Dollars is equivalent to the yield of the Global Bond 2025 plus 340 bps (410 bps in May 2009). In this sense, the spreads applied to mortgage loans in national and foreign currency maintain a similar level (see **Chart 11**), which could reflect similar exchange expectations between the bank and the market.

B.2. Payment terms and loan-to-value

Although a decline in the average payment terms for debt (because of the aversion of consumers to go into debt) could be expected, according to market information, there would not be great changes in the average payment terms of the new mortgage loans, which would remain in a range between 10 and 15 years.

On the other hand, we estimate that the loan-to-value (defined as the ratio between the amount of the loan and the value of the mortgaged real estate) may be reduced in the coming months, due to: (i) people would be making a bigger down payment (less debt as a percentage of the value of the real estate) and (ii) real estate property values have remained stable in recent months.

B.3. Delinquency rate: at low levels, slight warning signs

During recent months, the delinquency rate on mortgage loans has increased, although at a moderate pace. In this way, at the close of June, the delinquency rate of mortgage loans was at 0.84%, after having reached a minimum of 0.71% in September of 2008 (see **Chart 12**). These rates will be a reflection of a correct risk period on the part of the financing entities.

In any case, since delinquency remains at levels below 1%, the risk category of debtors has been decreasing since the end of 2008. Likewise, the percentage of debtors with potential problems (CPP), deficiency, and delinquency have increased by 3.6% as of the close 2008 to 4.4% at the end of the second quarter of 2009.

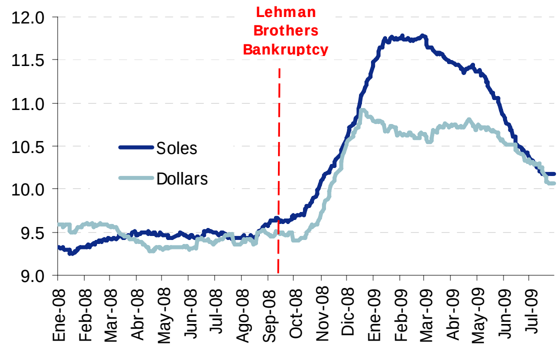
It should be indicated that it is possible that delinquency as well as the percentage of debtors with late payments may increase in the coming months. However, the situation is much better than the records from the end of the 1990s (at the close of 1999, the proportion of mortgage loan debtors classified as CPP, deficient, and delinquent reached 16.8%).

B.4. Dollarization: exchange uncertainty aids to decrease it

At the close of June, the dollarization of mortgage loans was at 64.2%, 11 percentage points less than the same month of the previous year (see **Chart 13**). This decrease is much more notorious in the flows of the last 12 months: as such, in the last 12 months, barely one-fourth of new loans were in foreign currency.

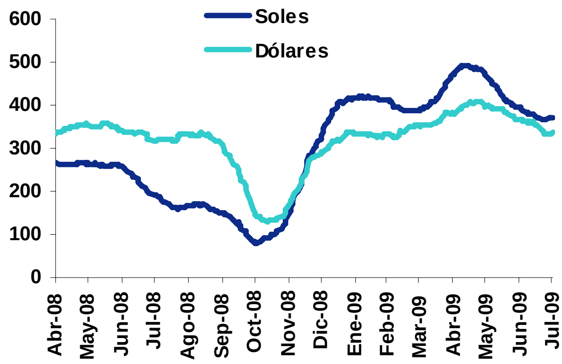
One of the reasons for the continued decrease in dollarization is exchange uncertainty and volatility in recent months. In fact, the exchange rate fluctuated between S/. 2.95 and S/. 3.30 per Dollar, without a clear increasing or decreasing trend. In any case, consumers would be choosing to not expose themselves to exchange risk.

Chart 10: Interest rate of mortgage loans *(%)*



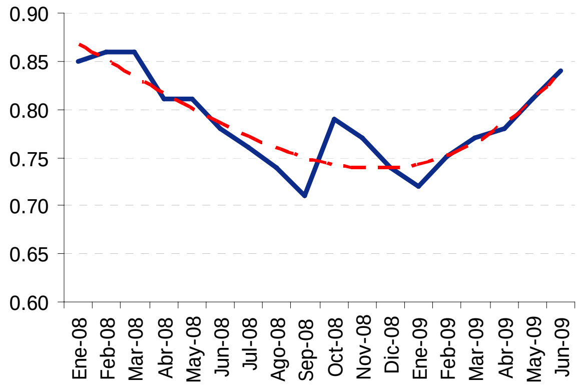
Source: SBS
Prepared by: BBVA Economic Research Department

Chart 11: Spreads of mortgage loan interest rates *(bps)*



Source: SBS
Prepared by: BBVA Economic Research Department

Chart 12: Delinquency of mortgage loans *(%)*



Source: SBS
Prepared by: BBVA Economic Research Department

Likewise, another fact that contributes to the dedollarization of mortgage loans is the possibility that banks offer long term loans in Soles at competitive rates. Therefore, up until 2005, interest rates in national currency were 5 percentage points higher than the rates in Dollars. Currently, the difference is barely 10 bps.

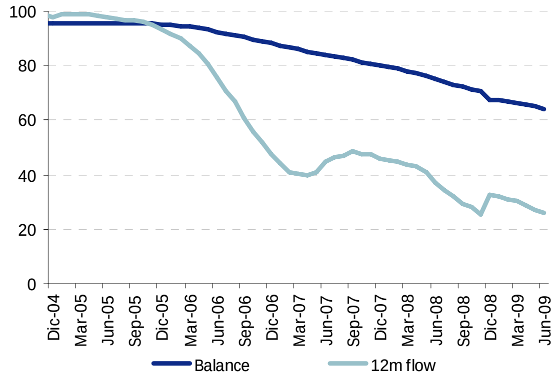
This has been possible, partly, thanks to the issuance of Sovereign Bonds (in Soles) from the Peruvian government, which allows the creation of a benchmark for long term interest rates in Soles.

B.5. Market share

The market share of banking entities in mortgage loans has varied slightly between June 2008 and June 2009, although they maintained the same positions (see **Chart 14**). In this sense, Banco de Crédito BCP remains in first place in the system, with 35.5%, followed by BBVA Banco Continental with 31.4%. Third place is held by Scotiabank (13.6%), which recently acquired the mortgage holding of Banco del Trabajo (Work Bank). Interbank is in fourth place with 10.5%, and a group of 7 banks make up the remaining 9%.

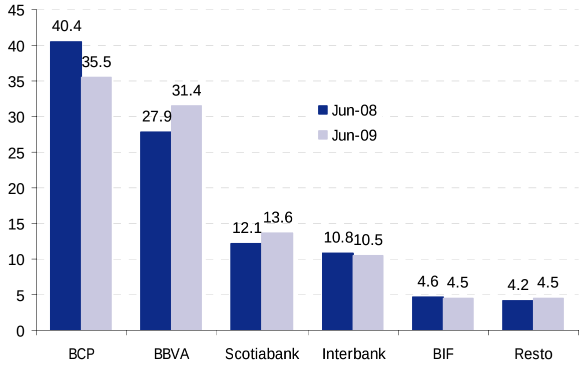
It is important to state that the mortgage loan market still has a wide margin to continue growing, since it maintains a low penetration with respect to the GDP (3% in 2009), varying from other countries in the region that have a more profound mortgage market, like Chile (15% of the GDP) and Mexico (11% of the GDP).

Chart 13: Dollarization*of mortgage loans *(%)*



* Assuming a constant exchange rate from June 2009
Source: SBS
Prepared by: BBVA Economic Research Department

Chart 14: Market share in mortgage loans *(June 09 - %)*



Source: SBS
Prepared by: BBVA Economic Research Department

4. The Real Estate Market

The grouping of supply and demand factors, and other financing conditions previously mentioned, has created a situation of lower levels of home sales YTD in 2009, and also in the stagnation of prices with respect to what was recorded in previous years.

Sales show a slight recuperation

According to the figures from the consulting firm Tinsa, home sales in the Lima Metropolitan area reached a minimum in the fourth quarter of 2008, and since then they have been showing a modest recuperation (see **Chart 15**). In any case, the current sales level (2,500 homes per quarter) is similar to what was recorded in 2007, and 34% less than the average of the first three quarters of 2008, in which an average of 3,800 homes were sold per quarter.

These figures concur with the trends found in the Construction Sector Survey by the Central Bank from April 2009. Here, 89% reported that sales remained stable with respect to the previous quarter, while 11% indicated declines (on the other hand, in July 2008, 42% reported improvements, 50% a similar level, and only 8% a drop in sales levels).

In this context, we estimate that home sales in Lima in 2009 will reach 11,300 units (see **Chart 16**), 17% below the sales reached in 2008 (a year with an exceptionally high level of sales), although 7% above the levels from 2007.

Projects continued being incorporated into the real estate supply

Despite the decline in sales, during recent quarters, the projects that have entered the market have increased, going from an average pace of 50 projects in mid-2008 to an average of 150 in the first quarter of 2009. In this way, at the close of the second quarter, there were 608 projects with homes for sale in the Lima Metropolitan area, with and average of 19 units per project.

The reason that the real estate supply continued to increase despite the small demand could be in the subtle downturn of the sector, that surprised many companies when they were already in the construction phase.

This excess of supply can be reflected as a ratio that divides the stock of offered homes between the monthly sales level, which indicates how many months it will take for the current supply to run out, given the current level of sales. In this sense, as can be seen in **Chart 17**, the indicator has increased from a minimum of 7.2 in the third quarter of 2008 to 13.1 at the close of the second quarter of 2009.

Prices remain relatively stable

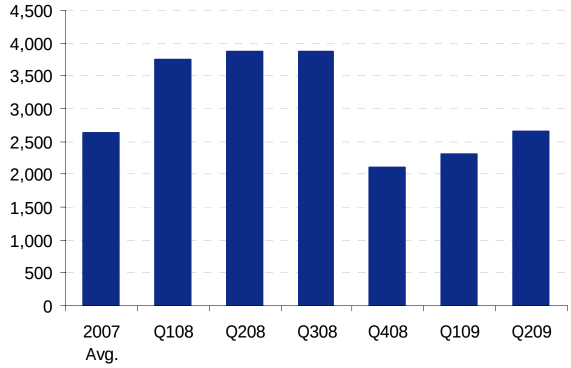
Differing from what occurred in real estate markets in the United States or Spain, housing prices have remained stable in Lima, and they even increased slightly. In fact, according to information from Capeco districts[1], we estimate that the average prices of square meter for apartments in the Lima Metropolitan area have increased 3% between July 2008 and March 2009, going from US$741 to US$763 per square meter.

The main cause that could explain this increase is that the current homes were built with land and supplies acquired by construction companies at high prices. Given that an apartment building can take 9 to 18 months to build, the current prices would still reflect the prices of materials and land from 2008.

It should be mentioned that, in terms of the expectations of companies in the sector, there is no consensus regarding the evolution of sales prices in the coming months, although a decline is perceived (see **Chart 18**). Between the second and third quarters of 2008, 50% were expecting an increase in prices,

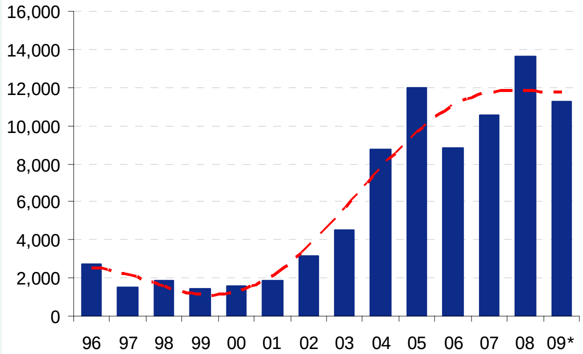
[1] This includes information from 14 districts of the capital city, which represent 80% of home sales.

Chart 15: Home sales in Metropolitan Lima (units per quarter)



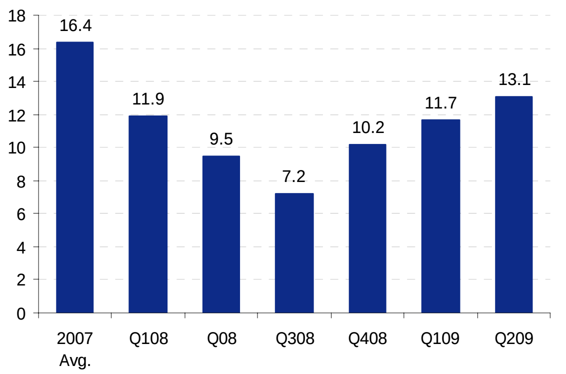
Source: Capeco, Tinsa
Prepared by: BBVA Economic Research Department

Chart 16: Housing sales in the Lima Metropolitan area *(units per year)*



* Forecast
Source: Capeco, Tinsa
Prepared by: BBVA Economic Research Department

Chart 17: Housing stock in Lima *(in terms of monthly sales)*



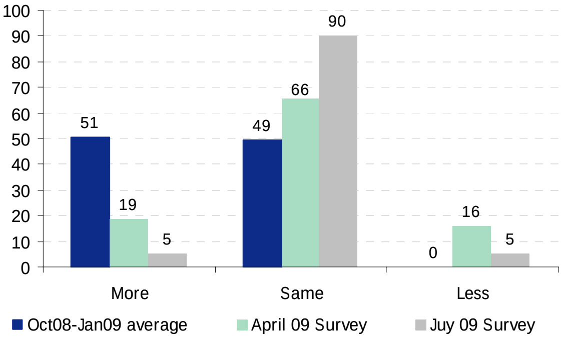
Source: Capeco, Tinsa
Prepared by: BBVA Economic Research Department

and the other 50% stable prices; towards the end of 2008 and beginning of 2009, the opinions were much more divided: 20% expected an increase, 60% expected that the prices would remain the same, and the remaining 20% expected a decline in prices.

With this information, we estimate that in the coming months, prices could show a slight downturn of between 5% and 10% (see **Chart 19**), due to: (i) the incorporation of new projects that have been seen as benefiting from better prices for materials or land, (ii) a higher supply that will begin to materialize in the market over the coming months, (iii) the weakness of the housing demand, (iv) the declining price expectations on the part of consumers, which will postpone their purchasing decisions until seeing a decrease in housing prices.

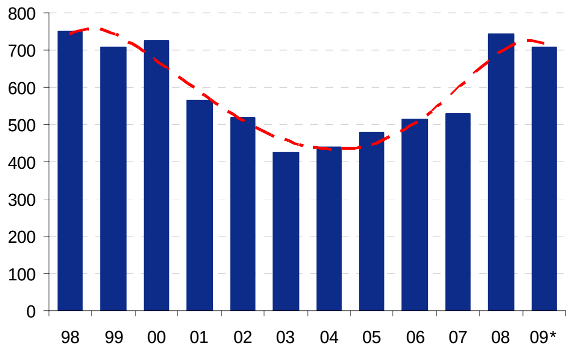
It should be mentioned that this decrease in prices will be concentrated, principally, on homes aimed at the socio-economic sectors with higher incomes, due to: (i) the homes destined for these sectors were those which experienced the largest increases in previous years and (ii) in contrast with what occurred in low-income sectors, there is no housing deficit in the large part of potential clients, only the wish to obtain a larger home, or one located in a better neighborhood.

Chart 18: Sales price outlooks *(next 3 months - %)*



Source: BCRP
Prepared by: BBVA Economic Research Department

Chart 19: Sales prices in the Lima Metropolitan area *(US$ per m²)*



* Forecast
Source: Capeco
Prepared by: BBVA Economic Research Department

Real Estate recession and market: experience and lessons from the 1990s

The financial crisis at the end of the 1990s that began with the Asian Crisis (July 1997) and continued with the Russian Crisis (August 1998) and Brazilian Crisis (January 1999), had a negative effect on the Peruvian economy, which after a five-year expansion period, suffered a severe restriction on external financing, causing liquidity problems for the national financial markets. There were also the effects of an additional shock: the El Niño climatic phenomenon. These events had serious consequences for the Peruvian economy.

The real estate market was not spared to the effects of this crisis. It was such that the indicators that describe this sector (price per square meter, home sales, access to mortgage loans, defaults and interest rates, among others) suffered greatly during the end of the last decade and the beginning of the present one, with a recent recovery beginning in 2002, at the same time as the Peruvian economy began to recover.

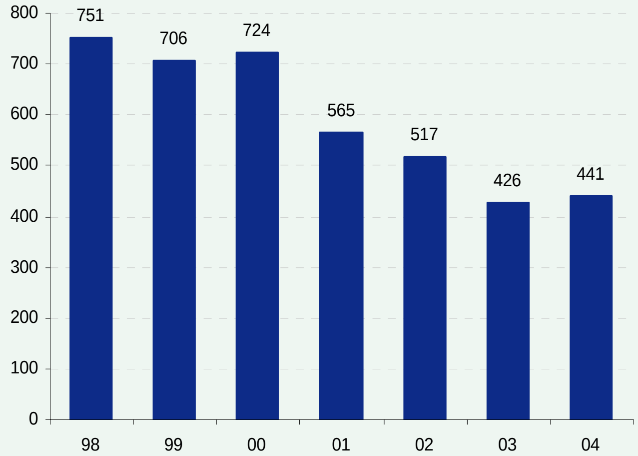
Effects on the housing market

During the 1990s, the socio-economic segments A and B were the ones that supported the real estate expansion, with a population that earned less income and thus had difficulties obtaining a mortgage loan.

With the arrival of the crisis in the late 1990s, in the middle of an urban building boom which focused on the higher-income classes, there was excess supply in a market whose size was relatively small. Thus, in 1998, only 40% of the more than 7,000 homes built in Lima's residential areas were sold, representing the real estate market's worst year since 1985. The result was a sustained decrease in rental prices and property sales.

According to figures from the Peruvian Chamber of Construction (CAPECO) during the period 1998-2003, the average prices of a square meter registered a drop of more than 40%, decreasing from US$ 750 to US$ 425 (see **Graph I**).

Graph I: Housing prices in the Lima Metropolitan area (US$ per square meter)



Source: CAPECO

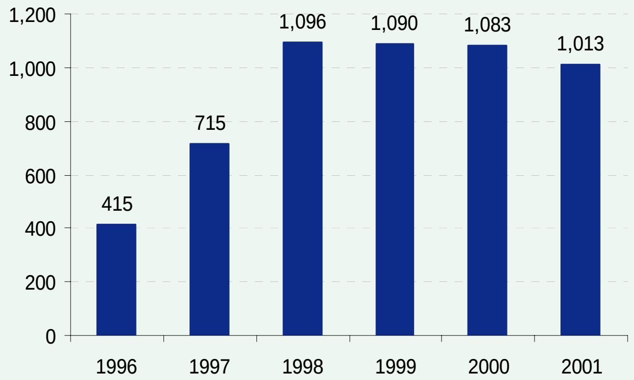
Another phenomenon that occurred during this period was an over 30% reduction in the average size of apartments, dropping from $130m^2$ to $90m^2$. Thus, in only 5 years, the value of an average apartment in Lima dropped 60%, due to both price and size.

Effects on the mortgage loan market

On the financial side, during the early 1990s, a significant expansion in mortgage loans was registered, primarily due to economic growth, the financial reform applied at the beginning of the decade and the abundant inflow of foreign capital. Furthermore, construction was one of the economy's fastest growing sectors, while mortgage loans carried very little weight in banks' loan portfolio (3% in 1996). All these factors led to a rapid increase in the mortgage loan balance, which in 1998 had reached approximately US$ 1.1 billion (2% of the GDP).

The strong growth that mortgage investments were registering stalled in 1999, due to the interruption in the inflow of capital into the banking system. As a result, the financial institutions curbed their granting of mortgage loans. On the other hand, the financial crisis also affected the real sector of the economy, causing the perception of the debtors' credit risk to rise and consequently, the granting of loans was subjected to even more conditions. Over the next years, the growth of these types of investments became stagnant, registering negative or practically null growth rates (see **Graph II**).

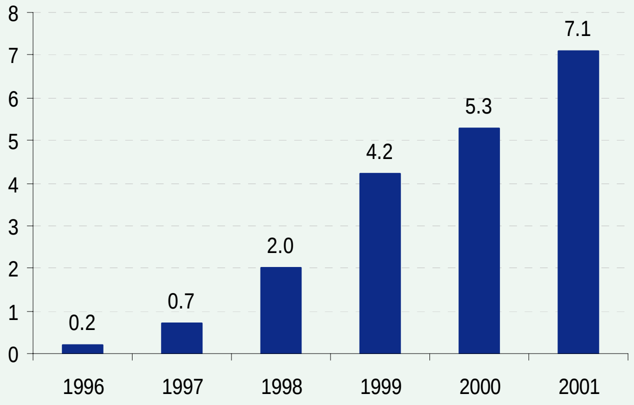
Graph II: Mortgage loan balance (US$ million)



Source: SBS

With regard to default rates, these types of loans sat at less than 1% until 1997, a factor that increased the banks' interest in serving this segment of the credit market. Nevertheless, with the slowdown of economic activity, default rates for these types of loans increased considerably, reaching a peak of 7.1% in 2001 (see **Graph III**).

Graph III: Default rate of mortgage loans (%)



Source: SBS

A key factor that explained the increase in mortgage loan default rates was the high dollarization of these types of loans (99% at the end of the 1990s), within a context in which most debtors received their income in new soles. Thus, between December 1997 and December 2000, the national currency depreciated 30% against the dollar, gradually increasing the payments of these loans.

What has changed with regard to this situation?

There are significant differences at the macroeconomic level that have made it possible for us to predict that it will be difficult to repeat a situation like the one witnessed at the end of the 1990s.

First, the position of the fiscal balance is currently more solid, which provides a margin for implementing countercyclical measures to help lessen the slowdown of economic activity.

However, when economic activity slowed down at the end of the 1990s, a rise in public spending was conditioned to obtaining external financing in international markets, which was also limited and very expensive.

Second, the banking situation has notably improved in recent years, with indicators pointing to high efficiency, adequate levels of liquidity, greater matching in its operations, low default rates due to effective risk management, and less dependency on short-term external financing (amounts owed abroad).

Third, the Peruvian economy has decreased its levels of external vulnerability. Currently, the current account deficit is at sustainable levels (2% of the GDP) and is financed primarily with long-term capital.

On the other hand, even in a case of capital outflows, the Central Bank is better able to stabilize the local currency, given that the international reserves equal 25% of the GDP, in comparison with 16% in 1998. This is very important since most of the mortgage loans are still foreign currency-denominated.

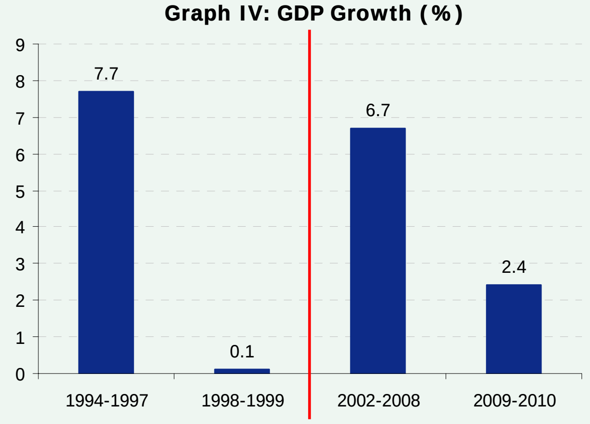
On the other hand, at the end of the 1990s, the growth of the Peruvian economy was, in large part, dependent on external saving. This resulted in an average current account deficit of 6.7% of the GDP between 1995 and 1998. This deficit was primarily financed with short-term loans that were channeled through the financial system.

This situation reverted itself in 1998; thus, between September of that year and September 2000, there was an outflow of approximately US$ 3.5 billion (6% of the GDP). This resulted in a loan restriction on the part of the banks (faced with a drop in financing sources) and a depreciation of the national currency as a mechanism for correcting the balance of payments, which affected the foreign currency-denominated loans (99% of the balance in 1999).

One of the most noteworthy events of recent years is precisely the drop in the dollarization of mortgage loans, particularly in the flows of recent years. Therefore, the proportion of new foreign currency-denominated loans is around 25% (99% at the end of the 1990s) and as a result, there is less credit risk associated with the depreciation of the national currency.

All these differences position Peru as a country with attractive macroeconomic fundamentals, in comparison with the previous crisis, and make it possible to soften the economic cycle (see **Graph IV**).

Graph IV: GDP Growth (%)



* Forecast
Source: BCRP, BBVA Banco Continental ERD

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II. Public sector measures to reduce the impacts of the crisis on the real estate sector

Since the beginning of 2009, the government has been adopting a series of measures to stimulate construction growth, and in particular, real estate activity in Peru. In fact, the resources destined to directly promote the housing demand in the public sector in 2009 reach S/. 1.3 billion, of which, about S/. 400 million will be destined for the Techo Propio (Own Roof) program.[2]

Stimulus from the Techo Propio program

The Techo Propio program is expected to be the main impulse to the construccion sector in 2009 and 2010. The government's goal for 2009 consists in the delivery of 50 thousand family housing bonds (BFH, direct subsidies for low income homes). However, considering the evolution of the program YTD, we estimate that the payouts could benefit up to 27 thousand families (see **Chart 20**), which would constitute a growth of 193% with respect to 2008 (9 thousand BFH).

It should be mentioned that the emphasis of the Techo Propio program has centered on a modality called Own Place (around 80% of the BFHs), linked to self-building before housing sales. This is due to the fact that this modality can be implemented faster than the loans associated with the housing mega-projects, which would only be able to change the sector in mid-2010, when it is consolidated and the works on projects like Collique (the most emblematic project located north of Lima, with 10 thousand homes destined to the Techo Propio program) are done. In this sense, the stimulus from the Techo Propio program would not be so marked in the sale of homes, even though it would in the construction sector that goes along with it.

Also, with the intention of promoting financing for low-cost housing for low-income socio-economic sectors, the government has reduced the requirements to gain access to the Techo Propio program (see **Box 1**).

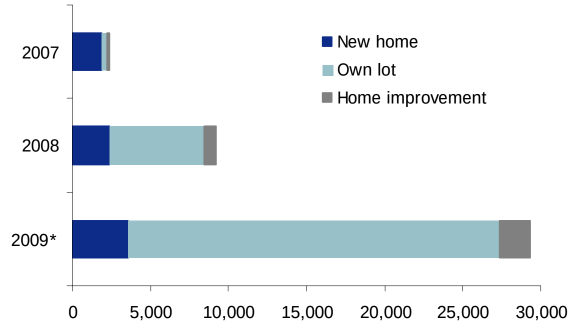
In this context, Fondo MiVivienda (a public Housing Fund) reduced its loan rates to the financial loan institutions complementing Techo Propio from 8.5% to 6.0% (250 bps). It is hoped that, with this measure, the interest rates for mortgage loans for said program will be reduced in a similar amount, going from 13% to 10.5% (from 17% to 14% in terms of the effective cost of the loan). As a matter of reference, and to insure the convergence of said interest rates to a certain point, it was also established that the Bank of the Nation (Banco de la Nación) charge 10% of the loans of said program.

Additionally, the down payment of the Techo Propio program has been reduced from 10% to 3% of the total value of the home. With this measure, the possibility of being able to access a home more quickly is given to families with lower economic resources, and at the same time, the time that it will take to save for the down payment is reduced. In fact, according to figures from MiVivienda, for a S/. 35,000 home, the amount of the down payment would now be equivalent to 1.6 times the minimum family income required by the financial system (5.5 times, before the measure).

Finally, the government authorized the Bank of the Nation to grant – in an exceptional way until the close of 2010 – a line of financing for a value of up to S/. 1 billion to companies from the financial system for mortgage loans for new, first-use homes.

[2] Techo Propio is a government program created in 1999, aimed at making housing financing easier to obtain for families with limited economic resources.

Chart 20: Payments of Techo Propio family housing bonds



* Forecast
Source: MiVivienda
Prepared by: BBVA Economic Research Department

Table 1: Change in the loan financing plan Techo Propio

	2008 Program	2009 Program
Conditions		
Interest rate (AER)	17%	14%
Term (years)	20	20
Down payment (%)	10%	3%
Relevant amounts (S/.)		
Price of the home	35,000	35,000
- Family Bond (BFH)	17,750	17,750
- Down Payment	3,500	1,050
Amount to be financed	13,750	16,200
Monthly payment	189	192
Minimum monthly income	631	639

Source: MiVivienda
Prepared by: BBVA Economic Research Department

Accelerated devaluation of real estate to encourage investment

One of the first measures adopted by the government was to increase the devaluation rate of works from 3% to 20%. This is equivalent to reducing the devaluation period of a real estate property from 33 to 5 years, which is known as accelerated devaluation.

With this measure, contemplated as a part of the Economic Stimulus Plan, the taxable amount subject to the payment of Income Tax will be reduced, due to the deductions from real estate devaluation. In this sense, the companies in the construction sector will have more resources to invest in new projects.

It should be mentioned that the measure is of a temporary nature (it will only be valid during 2010), and it only applies in the case of works that began in 2009 and that have a minimum of 80% completion of the work as of the close of 2010.

Promotion of new financing alternatives: covered bonds

One of the tasks that the government may focus on in the coming months is the development of new financing alternatives in order to facilitate the acquisition of housing. This necessity is evidence in that, while there are around 120 thousand homes financed through mortgage loans, the housing deficit in Peru has reached 1.5 million homes.

One viable option could be in a covered bonds plan, through which financial institutions issue titles backed up by a grouping of mortgages and high quality assets. It should be mentioned that, in contrast with what occurs when a holding of mortgage loans is securitized, the risk of the loan remains with the bank balance sheet (see **Chart 21**). This model is used predominantly in European countries (in comparison with the securitization model used in the United States). In Latin America, a successful example is Chile, a country with a mature mortgage market that represents 18% of the GDP. This market was initially stimulated by a system of mortgage payments, which has been functioning since the 1970s, and was almost the only instrument for financing a housing purchase until the beginning of the current decade.

The characteristic principles of covered bonds are the following:

i) they are issued by credit institutions (specialized or diversified) subject to supervision and regulation,

ii) the bond holders have priority rights over the assets that guarantee the issued titles (collateral) and also over the incomes derived of the same,

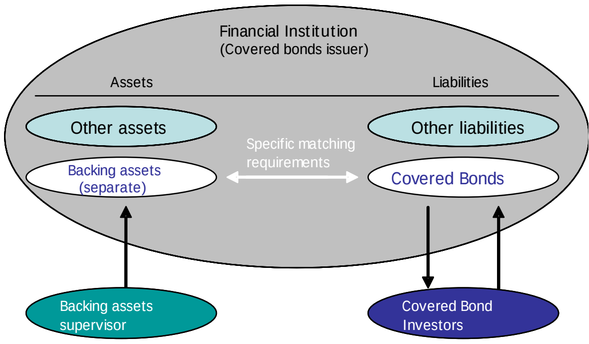
iii) the crediting institutions are obliged to maintain the quantity and quality of the guarantee assets,

iv) they have a simple and standardized structure (typically they are bullet bonds, that amortize the principle on the expiration date); and

v) some plans permit prepayment and transfer all of the market risk (interest rate) to the investor, while other penalize prepayment and guarantee the issuances in excess.

According to a technical mission from the International Monetary Fund (IMF), the development of covered bonds in Peru is feasible, although it would be required to reinforce, among other things: The judicial security of the investors with respect to the guarantees, making the procedures for the establishment of guarantees (eligible collateral, maximum loan-to-value, among others) uniform, and establishing a permanent supervision of the guarantees, principally in terms of the quality and ratio of payment terms. In order to assure compliance with all of these conditions, some countries have special legislation (for example, in Europe legislation assigns 10% of weighted capital risk to covered bonds, and makes the investment limits of institutional investors flexible).

Chart 21: Covered bonds plan



Source: BCRP
Prepared by: BBVA Economic Research Department

III. Outlook for 2009-2010

The slowing of economic activity and a greater backdrop of uncertainty, produced by the international financial crisis, has been reflected in a minimum pace of sales of new homes, and also in the evolution of mortgage loans.

In terms of the Lima Metropolitan area real estate market (homes built by specialized companies), we estimate that sales in terms of units will fall 17% in 2009, a level that will still be 6.7% higher than the recorded levels from 2007. Also, in 2010, sales will grow 15%, nearing the historic sales maximum that was reached in 2008 (a particularly high sales year in the first three quarters).

To minimize to impacts on the construction sector, the government has implemented a series of measures to stimulate said activity. The principle stimulus came from diverse housing programs, among those that stand out, Techo Propio (and in particular, the modality Own Place, which finances self-construction). Therefore, we estimate that the construction sector will grow 4% in 2009 and 6% in 2010, defining itself as one of the most dynamic activities in the country.

Finally, we should highlight that the long term outlooks for the sector are still favorable, due to structural factors such as the current housing deficit, population trends, the possibilities of mortgage financing penetration, and also the solid macroeconomic foundations of the country (high potential growth, macroeconomic stability, levels of investment).

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